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No. 81-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Supreme Court of California

MOTION OF NATIONAL ASSOCIATION OF MANUFACTURERS FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

AND

BRIEF *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

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QUESTION PRESENTED

California uses a formula for calculating corporate taxable income that attributes to California the same proportion of a company's entire income that property, payroll and sales in California bear to the company's entire property, payroll and sales.

The question is whether California's application of that formula to the combined income of a taxpayer and its foreign subsidiaries, which generally have lower wages and higher profitability, so unfairly apportions income as to offend due process.

A second question is whether that formula, which taxes income also taxed by the foreign subsidiaries' domiciliary countries, impermissibly discriminates against foreign commerce.

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

The National Association of Manufacturers hereby respectfully moves for leave to file the accompanying brief as *amicus curiae* in this case. The consent of the Attorney for the Appellant has been obtained. The consent of the Attorney for the Appellee has been denied as the Appellee intends to oppose jurisdiction.

The National Association of Manufacturers (NAM) is a non-profit voluntary business association incorporated under the laws of the State of New York. NAM has a membership of approximately 11,600 manufacturing and related business concerns representing an estimated 85 percent of all employees engaged in manufacturing nationwide. Further, of the member companies, a significant percentage have foreign subsidiaries and operations which provide foreign source income.

NAM members are located in forty-six states which have a state corporate income tax. NAM is concerned that the issues presented in this case could have broad reaching effect in other states where member domestic companies with foreign subsidiaries are located. We believe that unless this Court can resolve the issue of how the three-factor apportionment formula is to be applied to combined world-wide income from foreign and domestic operations, the interests of many of our members will be jeopardized in states other than California. Further, we believe that the application of the formula to worldwide income results in multiple taxation which is violative to the Commerce Clause. Thus, we feel this case presents the type of issue that is worthy of consideration by this Court.

Due to the diverse membership base of NAM, we believe that our filing a brief as *amicus curiae* will give a broader perspective on the issues presented to this Court on appeal.

Accordingly, NAM respectfully requests that it be granted leave to file the accompanying brief as *amicus curiae.*

Respectfully submitted,

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BRIEF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

INTEREST OF THE *AMICUS*

The interest of the *Amicus* National Association of Manufacturers (NAM) which consists of over 11,600 interstate and international companies, is set out in the accompanying motion of NAM for leave to file this brief as *amicus curiae.*

THE QUESTION PRESENTED IS SUBSTANTIAL

This case presents an important and unresolved constitutional issue: whether a state may, by its income apportionment formula, tax income of a taxpayer's foreign subsidiaries, which is already taxed by the subsidiaries' domicile nations.

California imposes a tax on the income of corporations doing business in the state. In the case of what it deems "unitary" or functionally integrated companies with foreign (or interstate) subsidiaries, California imposes its tax on the portion of the company's combined worldwide income that it deems allocable to California. It determines that portion by (1) calculating the average of three ratios (the ratios of the company's property, payroll and sales in California respectively to its property, payroll and sales worldwide) and (2) applying that average ratio to combined income of the taxpayer and its foreign subsidiaries. Cal. Tax and Revenue Code §§ 25101, 25128 (Deering).

1.a. *Due Process Requirements.* In extending its formula of income apportionment to include the "foreign source income" of a taxpayer's foreign subsidiaries, California offends due process by arrogating corporate income to the state out of all proportion to the income produced within the state.

This Court has held that a state may impose a tax on a non-domiciliary corporation doing business within the state, "if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444. That requirement is satisfied "if the tax is fairly apportioned to the commerce carried on within the State." *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169, 174; *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 452. In *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, 325, the Court stated the limits of a state's taxing power as follows:

> A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the

> peculiarities of a given enterprise, to "project the taxing power of the state plainly beyond its borders." *Nashville, C. & St. L.Ry. Co. v. Browning*, 310 U.S. 362, 365 (1940). Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing state. *Fargo v. Hart*, 193 U.S. 490, 499-500 (1940) [footnote omitted].

The Court has also approved state taxation of unitary businesses operating both within the state and abroad, provided a fair apportionment is made. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271, 282 ("the State was justified in attributing to New York a *just proportion* of the profits earned by the Company from such unitary business" [emphasis added]).

More recently, in *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425, 438-439, the Court sustained Vermont's taxation of dividends received by a New York corporation from its foreign subsidiaries, but only upon the stipulation of Mobil that the dividends were taxable by the taxpayer's U.S. commercial domicile (445 U.S. at 447) and that Mobil did not dispute "the accuracy or fairness of Vermont's apportionment formula" 445 U.S. at 434. As to the latter concession, the Court noted that this limitation by Mobil "substantially narrows the issues before us. In deciding the appeal, we do not consider whether application of Vermont's [three factor] formula produced a fair attribution of appellant's [foreign] dividend income to that State". *Ibid.* Thus the issue presented here of the arrogation to the State, by the three factor formula, of income of foreign subsidiaries remains open— and important.

b. *The Three-Factor Formula.* Nearly all states imposing corporate income taxes use a three factor formula, involving property, payroll and sales, to allocate income of unitary interstate businesses. See *U.S. Steel Corpora-*

tion v. Multistate Tax Commission, 434 U.S. 452; *Moorman Mfg. v. Bair*, 437 U.S. 267, 283, (Powell, J. dissenting). This results from the fact that the three factor formulas "while not perfect, reflect more accurately the realities of the business and tax world." *Moorman Mfg. Co. v. Bair, supra*, 437 U.S. at 282 (Blackmun, J. dissenting).

The basis of the general acceptance of the three factor system for apportionment of the income of interstate businesses is an assumption so fundamental that it is rarely stated: that each dollar expended for property or payroll or received from sales in one state has approximately the same relation to income as each dollar of property, payroll or sales in another state. While this assumption may be reasonable as applied to the relatively homogenous states of the United States, it wholly fails as applied to the foreign nations vis-a-vis a state of the United States. Foreign wages are generally lower than U.S. wages and the profitability of foreign subsidiaries generally higher. Thus, the application of the three factor apportionment system to the combined worldwide net income of multinational corporations inevitably apportions foreign source income to the U.S. taxing states and "project[s] the taxing power of the state plainly beyond its borders." *Nashville, C. & St. L.Ry. Co. v. Browning*, 310 U.S. 362, 365.[1]

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[1] As stated by then Assistant Secretary of the Treasury, Laurence N. Woodworth:

> Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case [with respect to subsidiaries in foreign nations]. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount

The distortions that are inherent in California's allocation formula can be demonstrated by an examination of the payroll element of the formula. Table I compares the average wages paid to manufacturing employees in a variety of industrialized and nonindustrialized countries. As that table demonstrates, compensation varies widely from country to country. For example, in 1978 (the most recent year for which final figures are available), the average hourly compensation in the U.S. was $8.31. By contrast, international salaries in 1978 ranged from a low of $.80 (or 9.6 percent of U.S. wages) in Taiwan to a high of $10.42 (or 125.4 percent of U.S. wages) in Luxembourg. Thus, for the same payroll expenditure, a company could receive 10 hours and 45 minutes of work in Taiwan for one hour of work in the U.S., or 45 minutes of work in Luxembourg. Even allowing for different rates of productivity, it is apparent that a strict dollar for dollar comparison of payroll costs will not accurately reflect the income attributable to expenditures in the U.S. and in other countries. This is particularly true in the case of labor intensive manufacturing industries.[2]

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to taxation by a state government of the foreign income of a foreign corporation.

Tax treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 34 (1977) (Statement of Laurence N. Woodworth).

[2] In this regard, Dr. Woodworth further noted:

> . . . [L]abor costs vary substantially among countries—very much more so than among regions in the U.S. If two affiliates, one in California and one in, say, Hong Kong, are engaged in essentially the same activities, the Hong Kong labor cost element in the formula will probably be lower than the California labor cost. A disproportionate amount of income will be apportioned to California. *Ibid.*

TABLE I

HOURLY COMPENSATION OF EMPLOYEES IN MANUFACTURING (Wages plus benefits)—1975-1980

Wages—Current U.S. Dollars

Country	1975	1976	1977	1978	1979 Estimated	1980 Estimated
United States	6.35	6.92	7.59	8.31	9.06	9.92
Austria	n/a	4.33	5.19	6.22	7.21	7.90
Belgium	6.60	7.02	8.38	10.18	11.91	13.18
Denmark	6.33	6.66	7.28	8.80	10.50	10.93
Finland	4.70	5.34	5.69	5.94	7.55	8.25
France	4.63	4.83	5.42	6.70	8.11	9.46
Germany	6.24	6.57	7.70	9.43	10.99	11.94
Greece	1.40	1.59	1.91	2.36	2.83	3.12
Ireland	3.01	2.86	3.24	4.13	5.22	6.38
Italy	4.65	4.42	5.13	6.18	7.54	9.01
Luxembourg	6.37	7.00	8.31	10.42	11.67	n/a
Netherlands	6.60	6.99	8.11	9.84	11.30	12.18
Norway	6.78	7.48	8.49	9.44	10.05	10.85
Portugal	1.58	1.66	1.58	1.63	1.68	n/a
Spain	2.55	2.85	3.19	3.83	5.35	5.96
Sweden	7.18	8.21	8.85	9.65	11.33	12.60
Switzerland	6.07	6.42	6.87	9.68	10.60	11.09
Turkey	0.70	0.89	0.80	1.05	1.11	n/a
United Kingdom	3.27	3.12	3.34	4.26	5.44	7.07

Canada	6.11	7.20	7.55	7.69	8.21	9.06
Brazil	1.13	1.29	1.46	1.67	1.73	n/a
Mexico	1.89	1.95	1.75	2.00	2.31	2.76
Venezuela	2.03	2.04	2.20	2.47	2.61	n/a
Australia	5.22	5.64	5.77	6.00	6.40	7.23
Hong Kong	0.71	0.87	0.99	1.13	1.25	1.51
India	0.19	0.29	0.32	n/a	n/a	n/a
Israel	2.25	2.37	2.68	2.57	3.30	3.68
Japan	3.05	3.30	4.03	5.54	5.59	5.88
Korea	0.37	0.47	0.63	0.85	1.11	1.10
New Zealand	3.08	2.87	3.24	3.97	4.52	5.09
Pakistan	0.21	0.23	n/a	n/a	n/a	n/a
Singapore	0.77	0.77	0.82	0.94	1.09	n/a
Tawian	0.48	0.56	0.66	0.80	1.01	1.25

Source: Unpublished Statistics Prepared by U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, March 1981.

This disparity is confirmed by comparing the portion of the total price of manufactured goods represented by labor costs. Table II sets forth the percentage of the total price of manufactured goods represented by payroll in nine industrialized countries. As that table shows, the

TABLE II

A

COMPENSATION AS A PERCENTAGE OF MARKET PRICE * OF MANUFACTURED GOODS

(1978)

Country	Percentage
United States	71.4
Japan	55.7
France	46.8
Germany	59.5
Belgium	65.3

B

COMPENSATION AS A PERCENTAGE OF FACTOR COST ** OF MANUFACTURED GOODS

(1978)

Country	Percentage
United States	75.2
Canada	69.1
Belgium	67.7
Italy	65.2
Sweden	83.0
United Kingdom	76.4

Source: Unpublished data prepared by the U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, May 1981.

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* The market price is the cost of manufactured goods, excluding government subsidies.

** The factor cost is the cost of manufactured goods, excluding indirect taxes, such as sales taxes, but including value added tax.

portion of the total price of a manufactured item represented by labor costs varies substantially from country to country, and for most countries the portion of total cost represented by labor cost is much lower than it is in the United States. Accordingly, the use of the payroll factor to apportion the income of multinational corporations necessarily malapportions income, taking for the taxing jurisdiction that has higher labor costs (here California) an inordinate share of such income.[3]

The misapportionment caused by the application of the three factor formula to combined worldwide net income is also shown by evidence of the higher profitability of foreign investments. At the trial Appellant's expert, Professor John McDonald of Stanford University, gave unchallenged testimony that corporations considering investments abroad will demand a higher expected rate of return ("hurdle rate") than they will demand for U.S. investments, because of the higher risks—principally political—associated with international ventures. Reporters' Transcript ("R.T.") pp. 12-18. He also testified that foreign investments tended, in fact, to produce a higher actual rate of return. R.T. pp. 23-25.[4] This gen-

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[3] The relatively higher ratio of payroll to sales was noted by Donald C. Lubick, then Assistant Secretary of the Treasury for Tax Policy:

> . . . [I]n the United States we may tend to have payrolls as a larger ratio of sales in the conduct of business than in many other jurisdictions. That means that the weighting of payrolls in the United States to total payrolls is going to allocate more income to a particular jurisdiction.

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 4 (1980) (Statement of Donald C. Lubick).

[4] These conclusions, while not challenged, were given as matters of expert opinion. The specific company by company data are considered confidential, *e.g.*, "these 'Hurdle Rates' are regarded by the companies that I know as proprietary information. The sort of thing they don't generally like to reveal to competitors, and they don't like generally to reveal this in their financial statements. . . ." R.T. p. 14.

eral higher profitability of foreign operations, again, rebuts on the world scale the assumptions of uniformity which make the three factor apportionment formula reasonable (and thus constitutionally permissible) as applied to the income of domestic companies.[5]

2. *Commerce Clause.* California's three factor apportionment system as applied to combined worldwide net income also offends the Commerce Clause because it leads ineluctably to multiple taxation of multinational corporations and "impair[s] . . . federal uniformity in an area where federal uniformity is essential." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434.

a. *Multiple Taxation.* In *Japan Line, supra*, the Court considered Los Angeles' *ad valorum* tax on containers temporarily located in the County, but belonging to Japanese container ships. Because the tax was imposed on property having a substantial nexus with the County and fairly was apportioned, it would have been permissible if applied to instrumentalities of interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274. Nonetheless, the Court held that, because the prop-

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[5] The misallocation of income resulting from an erroneous assumption of uniform profitability was emphasized by Joseph H. Guttentag, on behalf of the Dutch Employers' Federation:

> "[P]olitical and economic risks of investment are substantially higher in foreign countries than they are in the United States. These higher risks of investment are reflected in higher rates of profitability in those countries. Because the worldwide combination formula assumes away the existence of these very real differences in profitability, it overstates 'instate' income and leads to state taxation of foreign source profits, which bear no relation to any business risk incurred in the taxing state, as if they had been earned there.

State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 314 (1980) (Statement of Joseph H. Guttentag).

erty sought to be taxed were instrumentalities of *foreign* commerce, the tax offended the Commerce Clause:

> When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations, beyond those articulated in *Complete Auto*, come into play. The first is the enhanced risk of multiple taxation.
>
> * * * *
>
> Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. [footnote omitted] [441 U.S. at 446, 448].

The risks of multiple taxation, deemed acceptable in a domestic context (*Moorman Mfg. Co. v. Bair, supra*), are unacceptable in the international arena:

> Even a slight overlapping of tax—a problem that might be deemed *de minimus* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned [441 U.S. at 456].

Los Angeles' *ad valorum* tax created risks of multiple taxation even though it was fairly apportioned:

> . . . [W]hereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur," *Washington Revenue Dept.*, 435 U.S. at 746-747, the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce " 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Evco v. Jones*, 409 U.S. at 94, quoting *J.D. Adams Mfg. Co.*, 304 U.S. at 311. [441 U.S. at 447-448.]

The concerns expressed in *Japan Lines* have not abated with the decision of *Mobil Oil Corporation v. Commissioner of Taxes, supra.* The issue of multiple taxation was stipulated out of the case by Mobil:

> By admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed. [445 U.S. at 447.]

The risks of multiple taxation created by the three factor apportionment system as applied to combined worldwide income are as great as those found in *Japan Line.* There the Court noted that the property in question was "owned, based, and registered in Japan . . . Under these circumstances, Japan has the right and the power to tax the containers in full." 441 U.S. at 451-452. Similarly, foreign subsidiaries of the U.S. companies domiciled abroad can be and are taxed on their income produced in those countries, usually as calculated on a separate accounting basis. As noted above, the three factor apportionment system attributes to California substantial amounts of income produced in foreign countries, and reported as income to those host countries. The inevitable result is double taxation.

b. *Interference with Foreign Commercial Policy.* In *Japan Line, supra,* the Court expressed a second concern peculiar to foreign commerce:

> [A] state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern. [441 U.S. at 448].

The Court perceived the need for " 'speaking with one voice' in regulating foreign commerce" to be both a constitutional requirement and a practical necessity. 441 U.S. at 451. While Congress' authority to regulate both interstate and foreign commerce is found in the same clause of

the Constitution, "there is evidence the Founders intended the scope of the foreign commerce power to be greater. [footnote omitted]." 441 U.S. at 448. The practical necessity arises from a likelihood of international retaliation, which would be aimed at the entire Nation, not merely the offending state:

> If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taking State, so that the Nation as a whole would suffer. [footnote omitted] [441 U.S. at 450]

California's three factor formula as applied to foreign commerce is contrary to national and international policy and poses a distinct threat of retaliation.

The national and international effort to rationalize taxation among sovereign states is principally revealed in the U.S. tax laws and in our tax treaties with other nations. Under federal tax law, U.S. companies conducting business through foreign subsidiaries are not taxed by the United States on the earnings of their foreign subsidiaries, as calculated on a separate accounting basis. Federal taxes are imposed on such earnings only when they are repatriated as dividends to the U.S. parent; taxes on such "foreign source income" are subject to an offset for foreign taxes paid. 26 U.S.C. 901-908. This same separate accounting approach—as opposed to apportionment to combined worldwide income—is the basis of our Tax Treaties in force;* is considered the "internationally

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* Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

accepted norm"; [7] and is embodied in the model convention proposed by the OECD (Organization for Economic Cooperation and Development), of which the United States is a member.[8]

Conversely, the practice of formulaic apportionment of combined worldwide income "has created, and continues to create, an irritant in the international relations of the United States. . ." [9] Such an irritant creates a potential for retaliation anticipated in *Japan Line*. This potential for retaliation is well illustrated by the United States' own reaction in the 1930's to extraterritorial taxation by France. France imposed a tax on dividends paid by a U.S. parent corporation with French subsidiaries "in the proportion that its assets in France bore to total assets." [10] When France vacillated on ratification of a treaty to resolve the problem, Congress enacted section 103 of the Revenue Act of 1934.[11] Now section 891 of the 1954 Code, that provision allows the President to double the U.S. tax rate for citizens or corporations of countries that impose discriminatory or extraterritorial taxes on U.S. citizens or corporations. Our own reaction to extraterritorial taxation only serves

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[7] *Ibid.*

[8] State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 301 (1980) (Statement of John S. Nolan, on behalf of the Confederation of British Industry).

[9] State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 301 p. 7 (1980) (Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

[10] State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Sess. 297 (1980) (Statement of John S. Nolan, on behalf of the Confederation of British Industry).

[11] *Ibid.*

to confirm the concern over international retaliation expressed by this Court in *Japan Line*.

CONCLUSION

In sum, the California three-factor apportionment formula, as applied to combined worldwide income, projects the state's taxing authority extraterritorially, doubly taxes foreign income, and disturbs international relations. In each of these, it violates both the Due Process and Commerce Clauses.

For these reasons, jurisdiction of this appeal should be noted.

Respectfully submitted,

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